

VZCZCXRO0653
PP RUEHLMC
DE RUEHYE #0364/01 1201216
ZNY CCCCC ZZH
P 291216Z APR 08
FM AMEMBASSY YEREVAN
TO RUEHC/SECSTATE WASHDC PRIORITY 7469
INFO RUCNCIS/CIS COLLECTIVE PRIORITY
RUCPDOG/DEPT OF COMMERCE WASHINGTON DC PRIORITY
RHEBAAA/DEPT OF ENERGY WASHINGTON DC PRIORITY
RUEHLMC/MILLENNIUM CHALLENGE CORPORATION WASHINGTON DC PRIORITY

C O N F I D E N T I A L SECTION 01 OF 03 YEREVAN 000364

SIPDIS

SIPDIS

E.O. 12958: DECL: 04/25/2018
TAGS: [ENRG](#) [ECON](#) [ETRD](#) [EFIN](#) [PGOV](#) [SENV](#) [SOCI](#) [GG](#) [RU](#) [IR](#)
AM
SUBJECT: ENERGY PRICES - THE TICKING TIME BOMB UNDER THE
NEW ARMENIAN PRESIDENT?

REF: 2007 YEREVAN 1265

Classified By: CDA JOSEPH PENNINGTON. REASON 1.4 (B/D)

SUMMARY

11. (C) With the imminent expiration of gas subsidies and a large expected price increase in its upcoming GazProm contract, Armenia faces the likelihood of a doubling of gas prices between now and the start of 2009. This threatens to create a serious crisis for Armenia's new President in a country where even relatively well-off persons have trouble paying for gas to heat their homes. The GOAM has announced modest plans to mitigate price increases for its poorest residents. However, its previous strategy of selling energy assets to keep energy prices (and public discontent) in check is not sustainable, as there are few assets left to sell.
End Summary.

WINTER GREETINGS - A DOUBLING OF GAS PRICES?

12. (C) Armenians this winter can look forward to a possible doubling of natural gas prices for both residential and industrial users, and a smaller but still significant increase in electricity rates. This will be the consequence of two developments: The May 1 expiration of subsidies on gas consumption, as announced by new Prime Minister Tigran Sargsian on April 16; and the likelihood of an increase of 50 percent or more in the price paid to GazProm under a new contract to take effect January 1, 2009, when the current (heavily concessional) contract expires. The combination of these two changes may triple the effective price of gas (paid at the border), and likely lead to at least a doubling of gas prices to residential consumers next winter.

13. (C) The IMF estimates that the May 1 expiration of the current subsidy could add one percentage point to the 2008 inflation rate. Factoring in such secondary effects as increased electricity and transportation costs, the economic effect in 2009 of both the expired subsidy and a higher contract price for gas could result in a one percent decline in Armenia's GDP and a contribution of three percentage points to its inflation rate.

EXPIRING SUBSIDIES

14. (U) The Russian energy giant GazProm has for some time provided gas to friendly CIS countries at prices well below market value, but in recent years has moved to charge market prices to all its customers. In March 2006, when the GOAM signed a new contract that doubled the price it paid from USD

55 per thousand cubic meters (tcm) to USD 110/tcm the GOAM kept the end-user price unchanged by selling the Hrazdan Unit 5 Thermal Power Plant (TPP) to GazProm and applied USD 189 million from those proceeds to subsidize gas consumers through the end of 2008; USD 50, 69 and 70 million were allocated to 2006, 2007 and 2008, respectively. Due to higher-than-projected consumption, by January 2008 that subsidy fund was down to its last USD 2 million; the GOAM has apparently been subsidizing gas prices from general revenues since then.

15. (U) The impact on consumers of this expired subsidy will not be fully felt until next winter. Natural gas powers 20-30 percent of automobiles in Armenia (as vehicle owners modified their engines to dodge high gasoline prices with subsidized natural gas), but winter heating accounts for about 45 percent of total gas consumption.

NEW GAS CONTRACT

16. (U) Tigran Sargsian announced April 16 that GazProm Chairman Aleksey Miller will visit Yerevan in May to negotiate a new three-year gas contract to replace the current one set to expire at year's end. Recent press reports have speculated that GazProm's Board of Directors plans to up its tariffs in Armenia, as it has previously in other CIS countries, in anticipation of eventually charging Armenia the same price paid by its European customers. Local experts expect a significant price increase under the new contract -- USD 180/tcm or higher. A recent article in the Russian newspaper Kommersant estimates the new price will be more along the lines of USD 165/tcm. Such a price will still be well below that charged to other CIS countries; Georgia

YEREVAN 00000364 002 OF 003

currently pays USD 270/tcm.

ELECTRICITY RATES STABLE FOR NOW

17. (U) Energy Minister Armen Movsisian said April 16 that the GOAM will keep electricity prices unchanged through the end of 2008. This should be manageable, for while 25 percent of Armenian electricity is generated from gas-powered thermal power plants, Armenia generates surplus hydropower through the spring and much of the summer, much of which is exported to Iran (which in turn exports surplus electricity to Armenia in the winter). However, electricity tariffs should also increase markedly next winter, though not as significantly as gas prices, as nuclear and hydro power will dilute the impact of the increased gas prices.

PROTECTING THE "MOST VULNERABLE"

18. (U) Anticipating a serious shock to consumers next winter, the new Prime Minister said April 16 that the GOAM is developing a program for the 2008-09 winter to protect "socially vulnerable" people from the impact of potentially steep energy price increases. This would largely be a continuation of a program already in place since January 1, 2008, under which 130,000 socially vulnerable families have had their gas consumption subsidized through a budget allocation of about four million dollars (an average of USD 30 per family over the year). From May 1, when the subsidies expire, the GOAM will provide a subsidy of AMD 700/month (about USD 2.25) to eligible households.

19. (C) A "typical" Armenian household might consume about 5,000 cubic meters of gas annually, which cost about USD 1,000 this past winter and may be double that next winter. The GOAM subsidy would offset less than USD 30. Even many relatively well-off Armenians had difficulty paying for gas at the previous subsidized rates, so this protection for the "socially vulnerable" seems unlikely to be very effective.

Some pensioners already report feeling duped; many voted for Serzh Sargsian for President in part because the GOAM increased monthly pensions by 75 percent as of January 1, 2008. However, that gain will be more than wiped out by increased energy prices.

110. (C) During a personal April 24-27 visit to the northwestern town of Stepanavan, Emboff encountered visibly angry citizens who voted for Sargsian and were now fretting how they would make it through the summer canning season and next winter. Some predicted that they would have to revert to cutting forest timber to heat their homes in light of the projected spike in gas prices. Note: During Armenia's severe energy crisis in the early-mid 1990s, many Armenian families survived by cutting down forests to heat their homes and provide cooking fuel, and Armenia was never heavily forested to begin with. The USG has spent millions to help reforest affected areas. The specter of a new energy crunch could threaten hard-won progress in our reforestation efforts, and put a damper on indigenous efforts to boost eco-tourism around the country. End note.)

THERE IS NOTHING LEFT TO SELL

111. (C) Deputy Energy Minister Areg Galstyan acknowledged to Econoff April 22 that while the coming winter is likely to be hard on Armenian energy users, the GOAM does not plan to revive gas subsidies. Asked if the GOAM might sell off other energy assets to fund such subsidies, Galstyan said there were no plans to do so, remarking that "there is nothing left to sell." (Comment: One asset the GOAM is likely to sell at some point is a 40-mile segment of the Iran-Armenia gas pipeline to ArmRozGazProm, which owns and is building the rest of the 200-mile-long pipeline that will connect to the Yerevan Thermal Power Plant and also connect to the country's gas pipeline network. This would be a logical move, since there seems little point in one pipeline having two different owners, and would also soothe Russian fears that a major point of the new pipeline is to wean Armenia off of Russian gas dependency. The proceeds, however, would not subsidize energy prices for long. The 40-mile segment runs from Armenia's southern city of Meghri on the Iranian border to the inland town of Kajaran. End Comment).

112. (C) While Galstyan said nobody knows what the new GazProm contract price will be, he believes it will still be below

YEREVAN 00000364 003 OF 003

current regional market prices and no more than USD 200/tcm. Convergence with European Union market prices is inevitable, he believes, though probably not yet in this next contract. He said that electricity tariffs are also likely to rise, due not only to higher gas prices but also to the need to generate revenue for several capital projects as well as to fund salary increases for Ministry staff.

AND THE BUDGET IS ALREADY IN TROUBLE

113. (C) Deputy Finance Minister David Avetissian confided privately to polchief that the Armenian budget is already under intense strain, and he predicted an economic and budgetary crisis by years' end. Avetissian said that the government is 35 percent ahead of last year in terms of advance tax collections, mostly from major business taxpayers. In other words, the government has already collected and spent money that was supposed to be collected later in the year, as tax authorities have asked key taxpayers to pay their taxes early, in effect borrowing from future tax liabilities. Avetissian predicted a record budget deficit this year, to be paid for with an expansion of the public debt and resultant higher interest rates. The new president's pre-election move to boost public sector salaries

has proved costly.

COMMENT

¶14. (C) It is probably no coincidence that the GazProm contract and government gas subsidies were structured to last through the February 2008 Presidential elections. Previously, the GOAM's leadership sold off publicly-owned assets to mitigate the impact of market-level energy prices and to ensure its political survival. New President Sargsian, whose election was likely helped by this subsidy strategy, must now pay the piper and face the public backlash likely to result from a doubling of gas prices. If anything can match a stolen election in its ability to arouse citizen outrage, it is likely a massive increase in energy prices in the middle of a cold winter. It is therefore not surprising that the GOAM is already announcing plans - meager as they may be - to mitigate the impact of higher energy prices. However, while a doubling of gas prices over a few months will create many negative economic consequences, in the long run the move toward a market price for gas should probably be welcomed, given the distorting effects and perverse incentives created by pricing any product below market level.

PENNINGTON